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Foreign Acquisition Activity in Canada: A Long-Term Perspective

by

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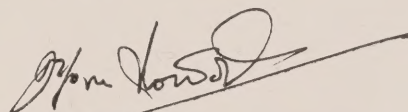
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FOREWORD

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FOREIGN ACQUISITION ACTIVITY IN CANADA: A LONG-TERM PERSPECTIVE

1. Introduction

This report examines recent cycles in foreign acquisition¹ activity in Canada and, more particularly, tries to throw some light on the extraordinary boom that took place in such activity in the 1968-70 period. This boom has generally been regarded in the limited amount of Canadian literature on acquisition activity in Canada as simply another cycle, albeit a strong one. But a review of the pattern of foreign acquisitions in Canada during the 1945-75 period, and the relationship between this pattern and a number of likely determinants, does not yield a satisfactory explanation. The study then examines longer-run factors and cycles in an effort to come up with a better answer. Finally, a few judgments are offered on the implications for future trends in acquisition activity in Canada.

2. Acquisition Activity in the United States and Canada

Trends since 1945 in acquisition activity in the United States and foreign acquisition activity in

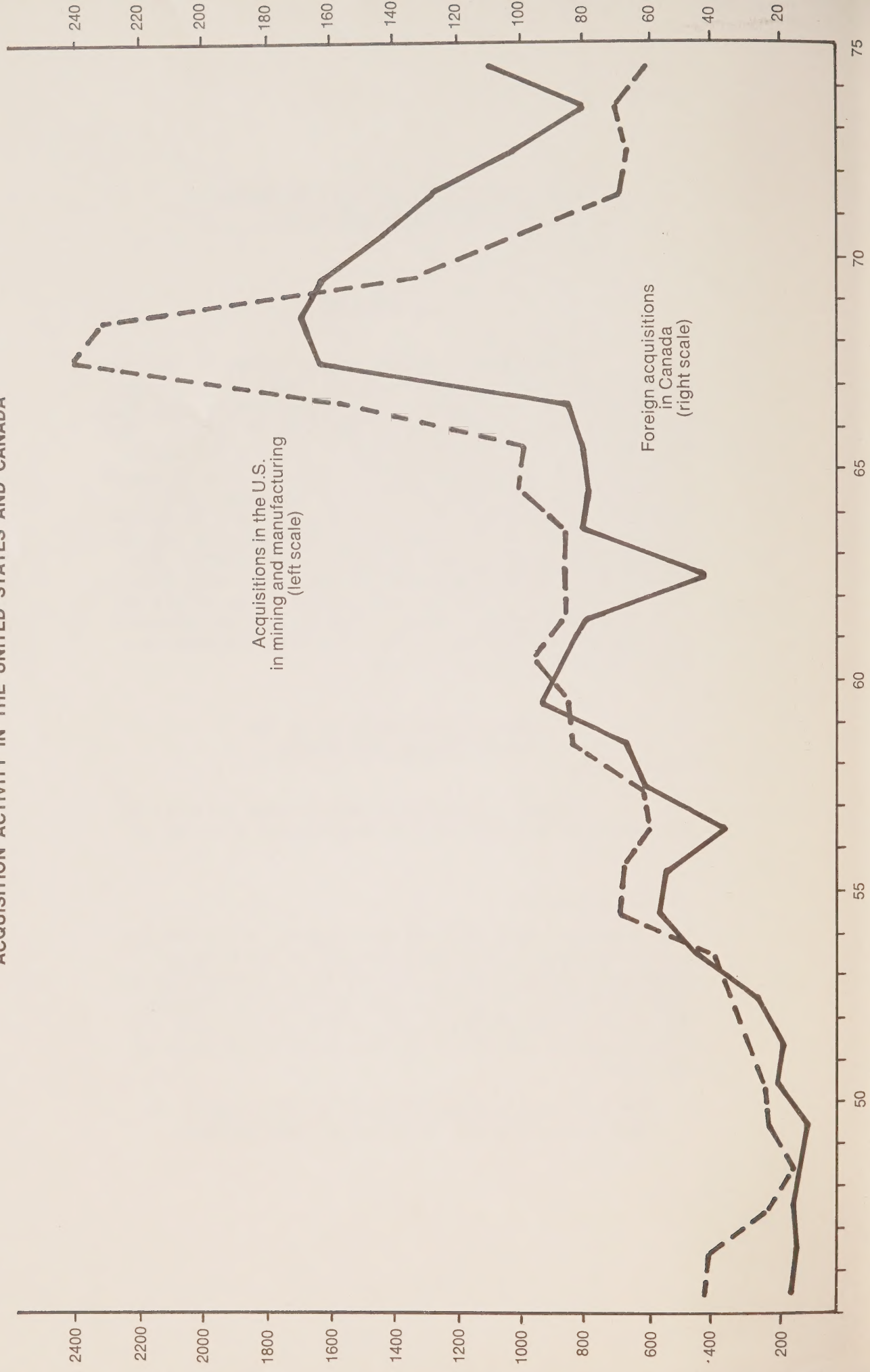
G.A. Edwards, the author of this report, is an officer in the Research and Analysis Branch of the Foreign Investment Review Agency. He wishes to acknowledge the contribution of Jim Wright, who worked as a research assistant at the Agency in the summer of 1976 and provided valuable assistance in the final preparation of the report.

1. The term acquisition, as used in this report, is synonymous with the terms merger and takeover.

U.S.

CHART 1
ACQUISITION ACTIVITY IN THE UNITED STATES AND CANADA

CDN.



Canada are illustrated graphically in Chart 1.² The chart shows a remarkably close relationship between levels of acquisition activity in the two countries. Growth trends and cyclical movements display similar configurations, with changes in the level of acquisitions in the United States appearing to lead those in Canada by roughly a year. Of particular interest is the fact that the major boom in acquisition activity which occurred in the United States between 1965 and 1969 was reflected in Canada from 1966 to 1970. Similarly, the substantial decline in activity in the United States in recent years has been followed in Canada, although both the boom and decline in acquisition activity were somewhat more pronounced in the United States than in Canada. It does not necessarily follow that acquisition activity in the United States is a determinant of foreign acquisition activity in Canada, since it is possible that the two series are influenced separately by similar factors in each country. However, there is obviously an extremely close relationship between the two series, and this relationship will be considered in more detail in this paper.

3. Indicators Related to Acquisition Activity

The patterns of acquisition activity in the United States and foreign acquisition activity

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2. Data on foreign acquisitions in Canada are from the Annual Report of the Director of Investigations and Research, Combines Investigation Act. Included are acquisitions involving a foreign-owned or controlled acquiring company (the nationality of the controlling interest in the acquired company could have been foreign or Canadian). The U.S. data are taken from the FTC Statistical Report on Mergers and Acquisitions published by the Bureau of Economics, Federal Trade Commission. The series includes only acquisitions of mining and manufacturing companies.

in Canada are shown in Chart 2, along with three commonly used series of U.S. and Canadian economic indicators. Each of these three variables -- stock prices, corporate profits after tax, and industrial production -- might be regarded as an indicator of the level of overall economic activity. Because of the substantial interrelationship that exists between them (eg., the influence of corporate profits on stock prices) they cannot properly be regarded as truly independent indicators. However, while it appears probable that some form of multiple correlation exists, with the level of acquisition activity being affected by the combined influence of these, and possibly other, indicators, the following section provides a separate discussion of the relationship between each of the three indicators and acquisition activity.

a) Stock Prices

Acquisitions are frequently effected by an exchange of stock between the acquiring and the acquired company. To the extent that rising stock prices tend to increase the "purchasing power" of the acquisition-minded company, they seem likely to exert a stimulative influence on the level of acquisition activity. In addition, the level of stock prices tends to reflect expectations regarding the future levels of corporate profits and general economic well-being. For these reasons it is reasonable to expect some correlation between the level of stock prices and the level of acquisition activity.

The pattern of U.S. stock prices shows, in some respects, a fairly close relationship with that of acquisition activity in the United States. The peaks in stock prices in 1955, 1960, 1965 and 1968 all coincide with either cyclical peaks or plateaus in acquisition activity. Similarly, the market declines of 1953, 1957, 1962 and 1966 also correspond fairly well with cyclical declines in acquisition activity. However, the movement of stock prices does not explain the extraordinary boom in acquisition activity that

occurred in the 1968-70 period, nor does it explain the very sharp drop in acquisitions that took place in the period from 1970 to 1974.

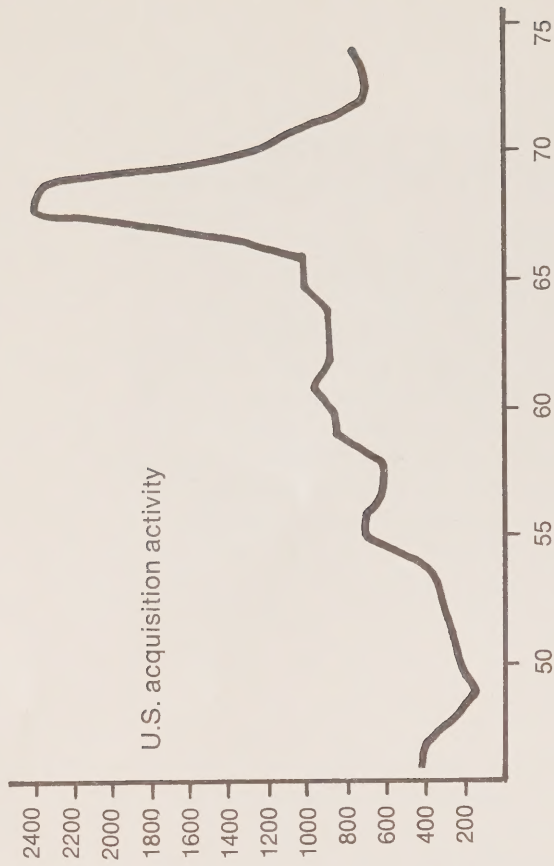
The relationship between stock prices and acquisition activity in Canada is similar to that in the United States. The market peaks of 1951, 1955, 1965, and 1968 coincide reasonably well with either peaks or plateaus in the level of acquisition activity. However, the pattern of stock price movements does not explain the decline in acquisition activity recorded in 1957 and 1963; nor, any more than the U.S. data, does it explain either the great surge or steep decline in acquisition activity in the late 1960's and early 1970's.

b) Corporate Profits After Tax

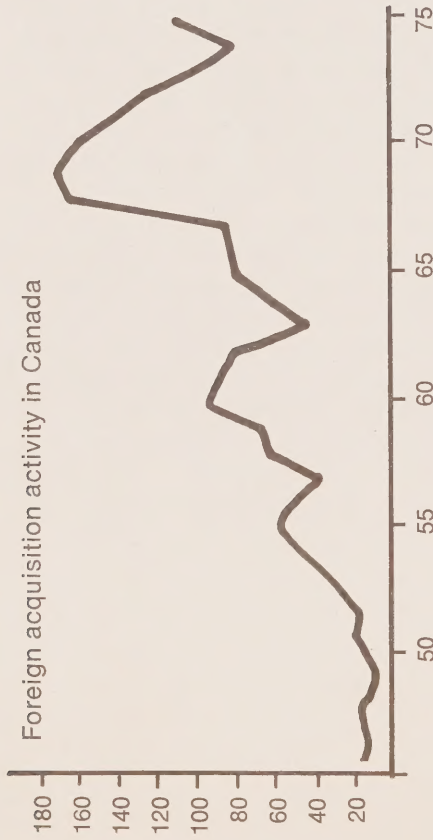
The level of corporate profits after tax is frequently used as a measure of general economic well-being, as well as an indicator of corporate liquidity. Consequently, it might be reasonable to assume that the level of corporate profits would be an indicator of the overall willingness and/or ability of companies to make acquisitions.

The trend of U.S. corporate profits after tax shows a modest degree of correlation with that of acquisition activity. The declines in corporate profits in 1953, 1957, 1960 and 1966 coincide with either a decline or a slower increase in acquisition activity. But, the trend of corporate profits in the 1965-68 period does not explain the striking surge in acquisition activity during that period. In similar fashion, the decline in profits during 1969 and 1970 coincides with the decline in the level of acquisition activity. But once again the decline in acquisition activity is disproportionately severe. Finally, acquisition activity displays a steady decline throughout the very strong rise in profits recorded in the period from 1971 through 1973.

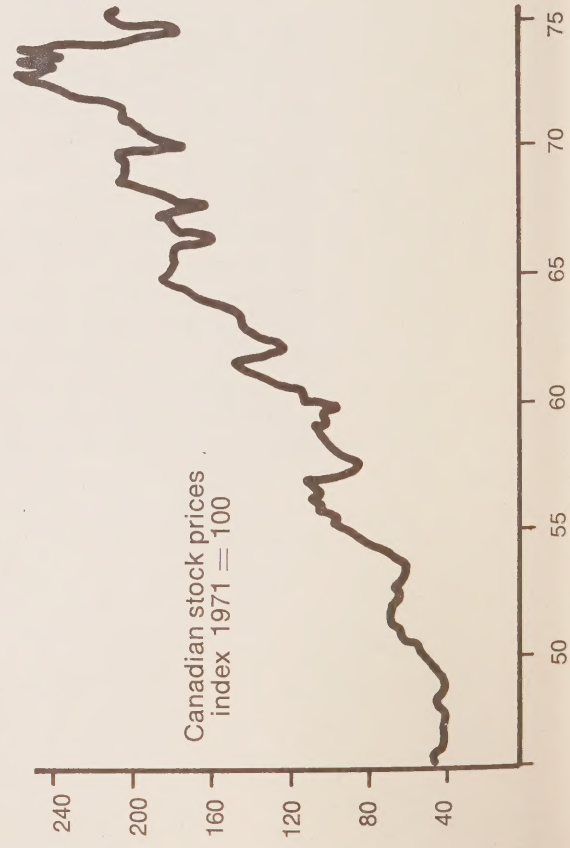
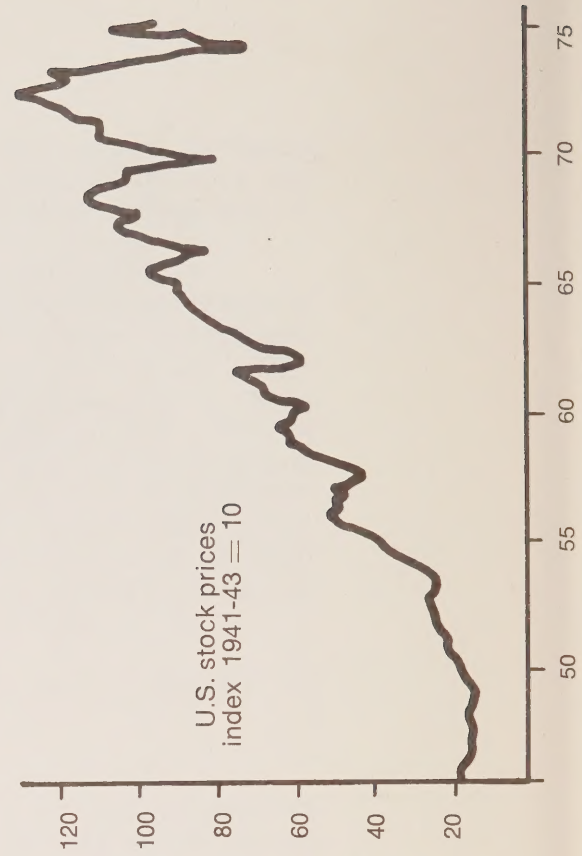
CHART 2
ECONOMIC INDICATORS OF ACQUISITION ACTIVITY

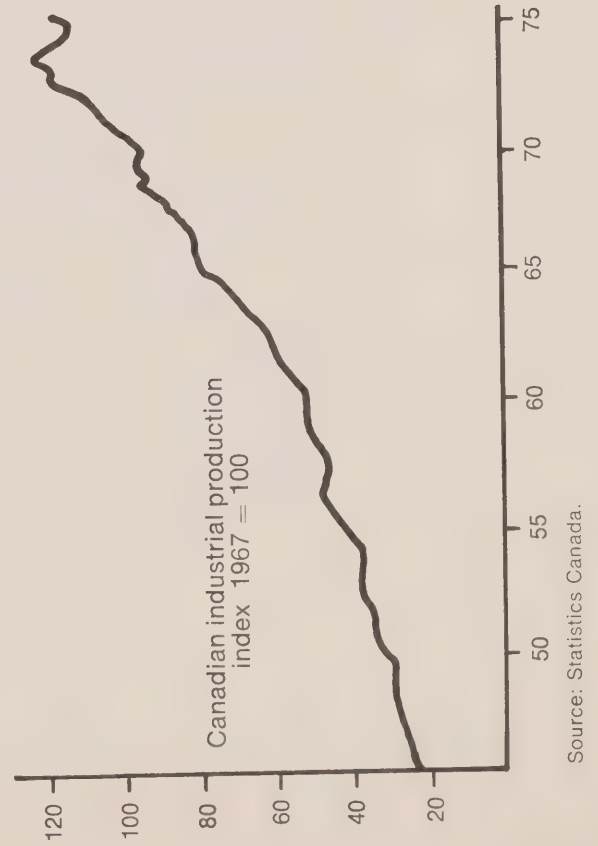
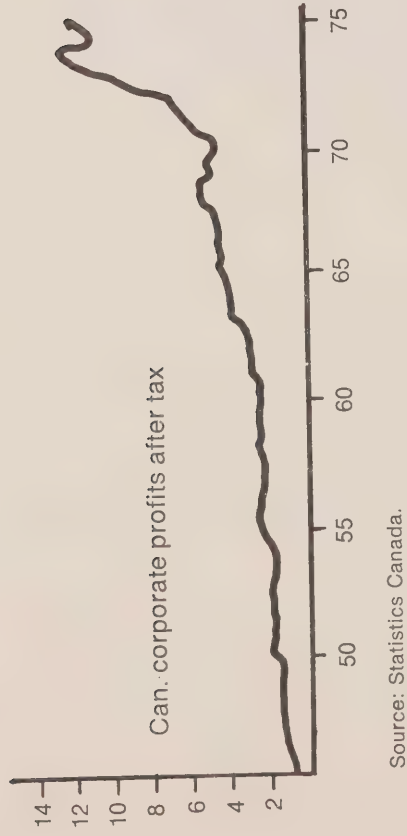
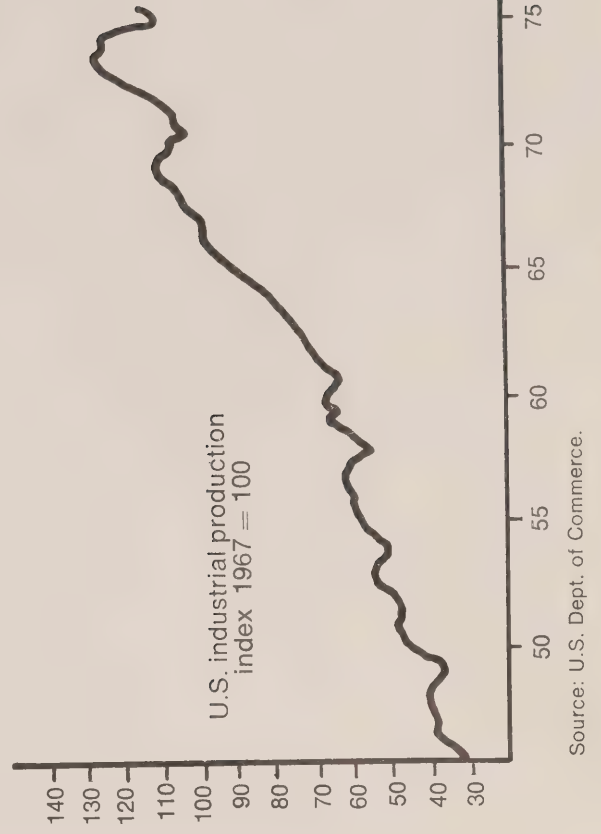
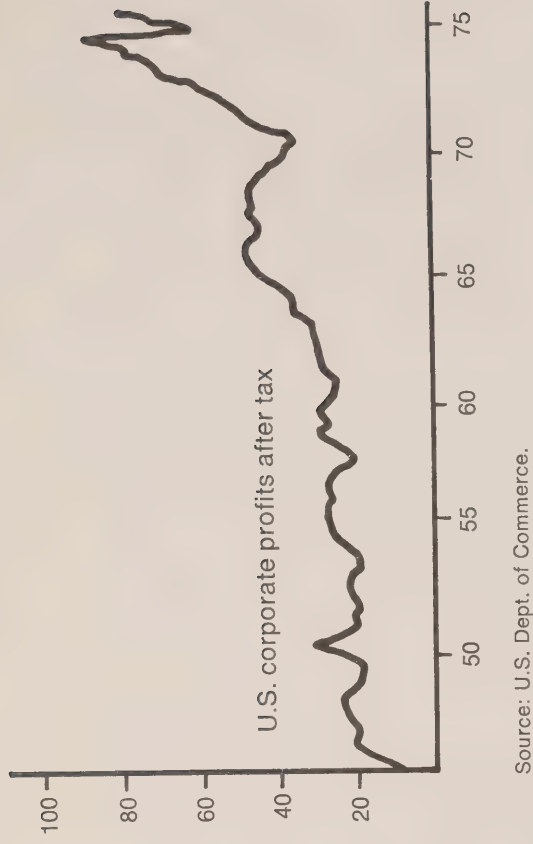


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The relationship between acquisition activity in Canada and Canadian corporate profits after tax is not as close as in the United States. And, again, there is no satisfactory explanation in the profits data for the boom-bust acquisition cycle of the late 1960's and early 1970's.

c) Industrial Production

Levels and trends of industrial production may be viewed as reasonably sound indicators of general economic activity. Since a rising level of economic activity is usually accompanied by rising profits, rising cash flows, and generally high future expectations, it seems reasonable to assume that common factors will influence both the level of industrial production and that of acquisition activity.

The chart suggests that there is a relationship between acquisition activity and industrial production, but a somewhat tenuous one. In both the United States and Canada industrial production and acquisition activity displayed generally rising trends throughout the period under review. In addition, a slowing in the rate of increase in industrial production was often accompanied by a decrease or slower rise in acquisition activity. But in neither country does the pattern of industrial production explain the major acquisition cycle of the late 1960's.

d) Other Economic Indicators

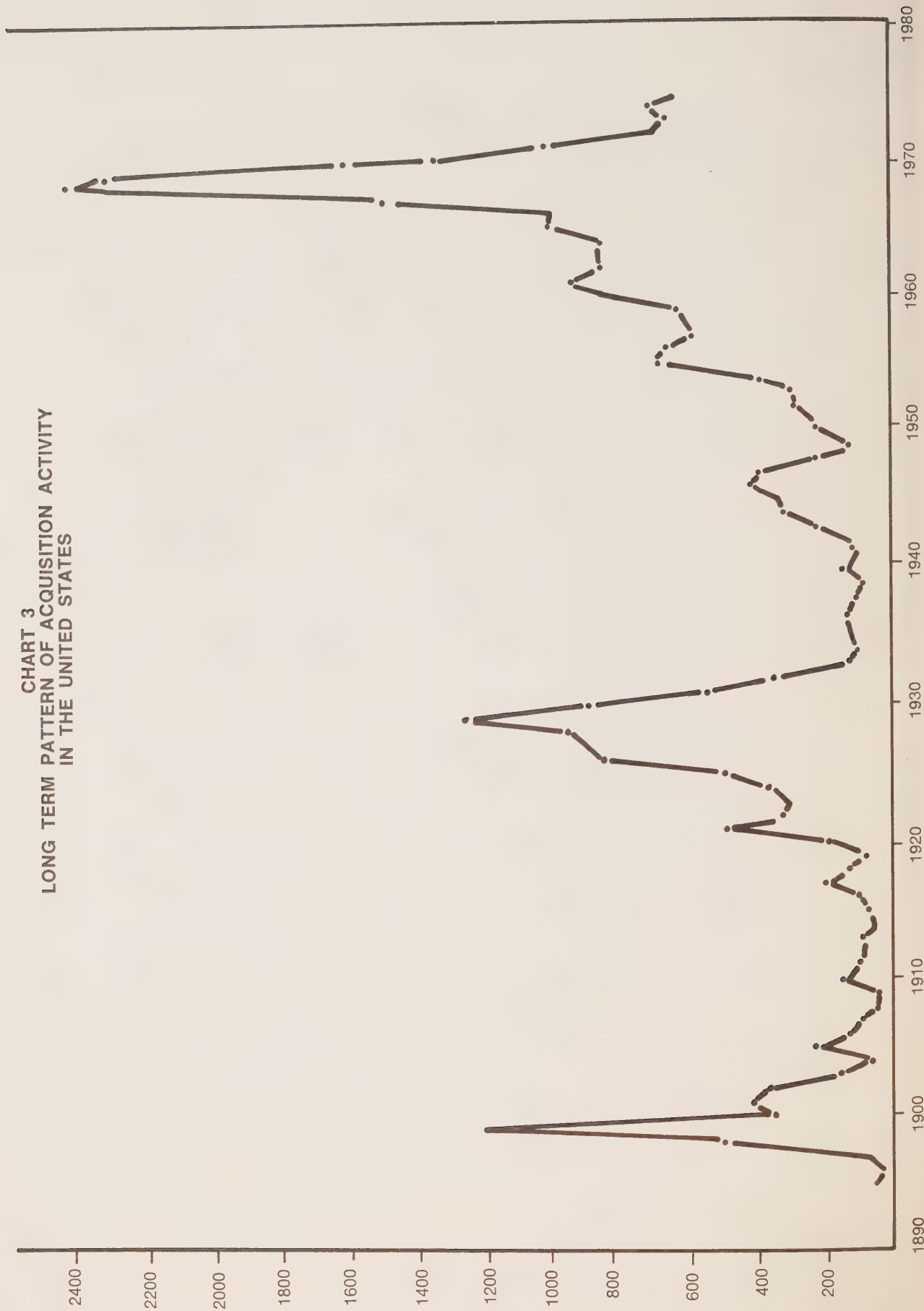
An examination was also made of the relationship between acquisition activity and a number of other indicators, including new business incorporations, business failures, interest rates, stock exchange trading volume and the dollar value of net new issues of common stocks. There appears to be little, if any, relationship between acquisition activity and either new business incorporations or business failures. Similarly, the level of interest rates appears generally

to have little effect on acquisition activity, although the recent extended decline in acquisition activity does coincide with a period of record-high interest rates.

Acquisition activity appears to show some degree of correlation with both stock exchange trading volume and the dollar value of net new issues of common stocks, but not as high a degree of correlation as with stock prices. And, since both trading volume and net new issues of common stocks are variables which commonly reach a peak at, or near, a peak in stock prices, it seems reasonable to infer a more important influence from stock prices and only a lesser influence, or perhaps no independent influence, from the other two of these three variables on the level of acquisition activity.

To summarize, it appears that foreign acquisition activity in Canada is very closely related to acquisition activity in the United States. In addition, stock prices appear to be the best indicator of acquisition activity. However, neither stock prices nor any of the additionally noted economic indicators can account for the boom in acquisition activity that took place in both Canada and the United States in the period from 1968 to 1970. Nor do any of the indicators account for the very substantial decline in acquisition activity that occurred in the period from 1970 through 1973. This would suggest that some other factor or combination of factors must have contributed. An understanding of what this other factor or factors might be would be helpful in determining whether another major boom in acquisition activity can be expected in the near future and, in any event, what the outlook is for future trends in acquisition activity.

CHART 3
LONG TERM PATTERN OF ACQUISITION ACTIVITY
IN THE UNITED STATES



4. The Long-Term Pattern of Acquisition Activity in the United States

A review of longer-term patterns of acquisition activity in Canada and the United States might reasonably be expected to provide additional insight into the boom which took place in both countries during the late 1960's. However, since information relating to longer-term acquisition patterns in Canada is not readily available, an examination was made of only the longer-term patterns in the United States, for which a more complete set of data is available. In view of the similarity between patterns in the two countries since 1945, it seems reasonable to assume that earlier historical patterns are likely to have been similar as well. But in any event, the great similarity since 1945, plus the continuing growth of economic interrelationship between the two countries, strongly suggests that acquisition patterns in the two countries are likely to continue to be similar in the future.

The long-term pattern of acquisition activity in the United States since 1895 is shown graphically in Chart 3.³ Since then there have been

3. The data for the period from 1919 to 1939 are taken from the Report on Corporate Mergers and Acquisitions, published by the Federal Trade Commission in May, 1955. Data for the period from 1895 to 1918 are taken from Merger Movements in American Industry 1895-1956, a study carried out by Ralph L. Nelson and published by Princeton University Press in 1956. Although the FTC series and the Nelson series use somewhat different data - collection methods, the differences are not sufficient to alter the indicated long-term pattern of acquisition activity.

three periods in which acquisition activity rose sharply above the long-term trend, with peaks of activity occurring in 1899, 1929 and 1968. Each of these three booms in acquisition activity has displayed the following common features:

1. A period of hyper-activity lasting for a maximum of two years.
2. A peak in acquisition activity at or near a major peak in stock prices.
3. A steep decline following the peak in acquisition activity, with the period of decline spread over four or five years.
4. Following the steep decline, a period during which activity exhibits a moderate cyclical pattern but remains well below the level achieved at the peak of the boom.
5. The lack of an exceptional peak in production, commodity prices or overall business activity at the top of the acquisition cycle.

All three acquisition booms were accompanied by a rapidly rising stock market. But there were other occasions when a rising stock market was not accompanied by an increase in acquisition activity. In 1916, 1951 and 1971 the stock market reached a new record level, but acquisition activity remained well below its previous peak. In other words, while a rapidly rising stock market seems to be a necessary component in any acquisition boom, some additional special factor or combination of factors also seems to be required to bring about this infrequent boom-bust phenomenon. A review of the three separate booms in acquisition activity suggests that the factor may be the infrequent occurrence of an environment in which there is an exceptional economic justification for the consolidation of business organizations.

The first major wave of acquisition activity, which took place in the late 1890's, came about when significant changes in the structure of the U.S.

economy created a conducive environment. The principal structural change of the preceding decade had been the creation of a national railway network through the connection of hundreds of local and regional lines. The same era witnessed the completion of nation-wide telephone and telegraph systems. These two developments greatly reduced the cost, and increased the speed, of transportation and communication, and thus created, for the first time, national markets for many goods and services. At the same time, a national capital market had developed, and the increase in active public trading of industrial securities supported the consolidation of a number of basic industries into what were then termed trusts. Monthly trading volume on the New York Stock Exchange rose from 3.4 million shares in January, 1897 to more than 24 million shares in January, 1899, while the number of acquisitions rose from 69 in 1897 to 1,208 in 1899. By 1902 the number of acquisitions had declined to 379 and the average monthly volume on the New York Stock Exchange was down to roughly 16 million shares.

Although it was the emergence of national markets which provided the economic rationale for this first acquisition boom, the consequent creation of large trusts was carried out in a manner which suggests, to at least one author, that "the primary motivation in all but the rarest of cases was to reduce, eliminate or regularize competition. Each of the new giants dominated an industry and henceforth exercised measurable control over prices, production and perhaps, over investment and the rate of technological change."⁴

In many respects this first boom in acquisition activity was the most important of the three major cycles. The absolute level of activity -- 1,208 acquisitions in 1899 -- was remarkable in view of the relatively modest size of the U.S. economy. In fact, the level of acquisition activity reached in 1899 has been exceeded only four times in the subsequent 75 years.

4. J. K. Galbraith, The Great Crash, p.49

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The acquisition boom at the end of the last century also significantly altered the composition of a number of industries. Prior to the acquisition boom, most industries were characterized by many small or medium-sized firms. The emergence during this period of such dominant firms as U.S. Steel, National Biscuit Company, American Tobacco and American Smelting and Refining created an industrial structure in which many industries were dominated by one or a few large firms -- a structure which largely remains intact today.

The second boom in acquisition activity extended from 1924 to 1930, peaking in 1929 with 1,245 acquisitions. It, too, probably had its roots in changes in the economics of transportation and communication. The widespread ownership of cars and the creation of a national system of highways provided individual families with greatly increased mobility which destroyed many local monopolies. At the same time, the use of national advertising became significantly less costly and more effective as the number of households owning radios rapidly increased. By the mid-1920's major opportunities existed for firms to expand production facilities and distribution networks in order to serve this changing market.

During this period the holding company, created to hold the shares of other companies, became increasingly common. By 1928, 92 or approximately one-sixth of the companies traded on the New York Stock Exchange did nothing more than hold the securities of other companies. General Mills, National Dairy Products, Warner Brothers, and Commonwealth and Southern all trace back to this period.

There do not appear to be any comprehensive data available on foreign acquisition activity in Canada during this period, and so it is not possible to determine with certainty whether or not the acquisition boom in the United States had a counterpart in Canada. However, if foreign acquisition activity in Canada was in fact undergoing a boom during this period, one might reasonably expect that the number of acquisitions carried out by Canadian

companies would, for many of the same reasons, also be at a very high level. A survey of a number of major Canadian companies indicates that each of them made at least one, and often more than one, acquisition during 1928 and 1929.⁵ This suggests that the boom in acquisition activity which occurred in the United States in the late 1920's was probably accompanied by a high level of acquisition activity in Canada -- both by Canadian-based and by foreign-based companies.

The third and most recent acquisition boom in the United States began in 1965 and reached a peak in 1968, a year in which some 2,400 mining and manufacturing firms were acquired. It appears that there were three major factors contributing to this third acquisition boom. The first two were the application of management science to business decision-making, and the flexible accounting standards used throughout the period. A third factor was the decision of a segment of the investment management industry to concentrate their investments in those companies reporting the most rapid increases in earnings. These changes greatly aided the development and growth of the conglomerate corporation, a dominant feature of this period.

The introduction of management science to business decision-making was, of course, accompanied, and to a large degree promoted, by the increasing use of computers in business. This application of management science was designed to make possible a simultaneous reduction in risk and increase in earnings. The belief that mixes of very diverse productive assets could be managed efficiently was shared by both conglomerate managers and investors, and led directly to the rise of the conglomerate corporation.

5. Included in the survey were Consolidated Bathurst, Abitibi Paper, Alcan, Canadian Imperial Bank of Commerce, Noranda, Bell Canada, Domtar, Canada Cement, Maclean-Hunter, Maritime Telegraph and Telephone, and Traders Group.

A second important factor was the flexible accounting standards permitted during this period. Companies making an acquisition by way of an exchange of common stock were generally permitted to account for the acquisition as a "pooling-of-interests" rather than as a "purchase". In a "pooling-of-interests", there is no requirement to recognize or amortize the premium paid over the book value of the acquired company. Thus, the acquiring company could increase its earnings by the full amount of the target company's earnings and could effect a rapid increase in earnings through a series of acquisitions. In addition, because the assets of the acquired company were recorded at their historical and depreciated cost (book value), the sale of any of these assets by the acquiring company would create additional profits, although none in fact existed.

Even where the "purchase" method was used to account for the acquisition, and the acquiring company was required to recognize the premium paid over book value as goodwill, there was not at the time (as there is now) a requirement that the goodwill be amortized against future earnings. Thus, given such flexibility, almost every acquisition led to an immediate gain in the reported earnings of the acquiring company.

Since the shares of a conglomerate company were usually selling at a much higher price-to-earnings ratio than the shares of the target company, the conglomerate would, through a share-exchange acquisition, be increasing its earnings at a faster rate than the increase in its shares outstanding -- i.e., it would be increasing its earnings per share. Moreover, the expectation was that a strong market would value these new earnings per share at the high price-earnings multiple that had typified the stock of the conglomerate.

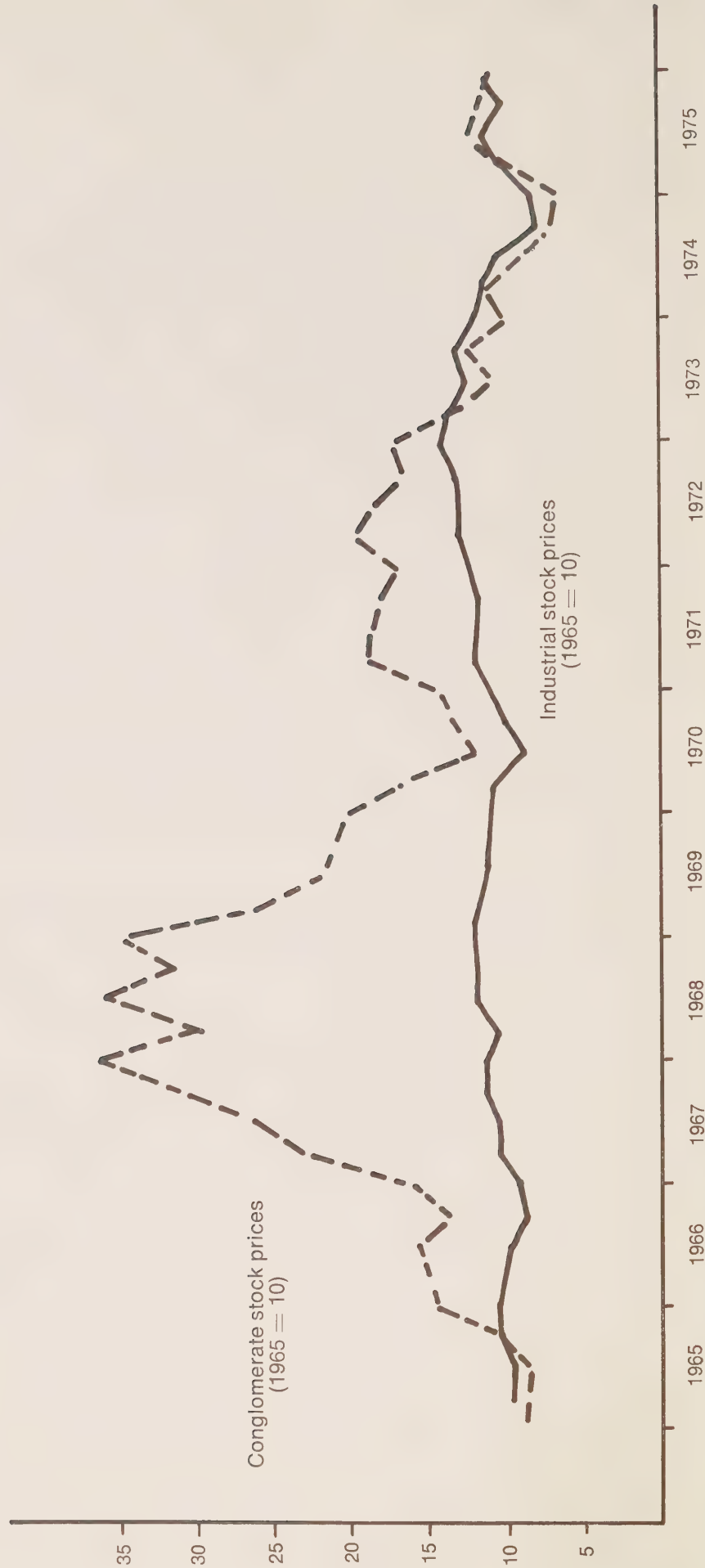
It was an ingenious system, and the expectation of the conglomerate company was usually fulfilled.

The conglomerate company was also able to exclude from the share base of its earnings-per-share calculation any securities issued to the acquired company which were not ordinary common stock (i.e., there was no requirement to report earnings on a "fully-diluted" basis). Thus, many acquisitions were accomplished partly or largely through the issuance of convertible debentures or warrants, which the conglomerate was not required to include in its share base when calculating earnings per share.

As in the two earlier acquisition booms, an active stock market again played an important role, with trading volume reaching record monthly levels of almost 300 million shares per month in the early part of 1968. In addition, the emergence of a sector of the investment management industry which was committed to obtaining performance at almost any cost greatly aided the acquisition-minded conglomerates. It was a mutually reinforcing phenomenon, with conglomerates needing high stock prices to achieve additional acquisitions and earnings, and the aggressive money-managers of the day contributing to, and benefiting from, the rising conglomerate stock prices which reflected both the stock-buying demand and the growth in conglomerate earnings.

During this period, rising prices of conglomerate stocks were a dominant feature of the stock market. Chart 4 displays the Standard and Poor Conglomerate Stock Index along with the Standard and Poor Industrial Index (both based on a 1965 value of 10). Between the first quarter of 1965 and the last quarter of 1968, the conglomerate index rose by 397 per cent while the broad industrial index rose by only 24 per cent. The performance of the conglomerate stocks partly reflects the rapid rise in the reported earnings of most conglomerates. For example, the earnings of Litton Industries, a leading conglomerate of the day, rose from \$0.30 per share in 1960 to \$2.13 per share in 1967. Over the same period the price of Litton stock rose from \$15 to \$101 per share. By 1974 the company was reporting a loss and the price of the shares had fallen to under \$3.

CHART 4
 CONGLOMERATE STOCK PRICES
 AND
 STANDARD AND POOR'S INDUSTRIAL INDEX



5. The Current Outlook for Acquisition Activity

The excesses which marked the 1968-70 acquisition boom in the United States set in train a number of changes in the regulatory environment. One of the most important was the introduction in 1969 and 1970 of new standards to be used in the accounting treatment of acquisitions. The new standards greatly reduced the use of pooling-of-interests accounting, the use of which became restricted to those acquisitions which met a specific set of criteria. They also specified how goodwill (the excess paid by the acquiring company over the book value of the acquired company) should be treated, requiring that it be amortized against the earnings of the acquiring company. In addition, new standards required that all convertible and equity-like securities be included in the calculation of per-share earnings. In combination, these changes greatly reduced the opportunities for acquisition-minded companies to report gains in earnings where no real improvement existed.

Accompanying these changes in accounting standards were new reporting requirements introduced by both the U.S. Federal Trade Commission and the U.S. Securities and Exchange Commission. The Federal Trade Commission now requires that a public statement be made in advance if any company with more than \$250 million in sales plans to acquire another company with sales in excess of \$10 million. The Securities and Exchange Commission, as a result of the Williams Act of 1969, now requires a disclosure of intention to merge by any corporation acquiring five per cent or more of another corporation's stock.

A significant change was also made in the U.S. tax laws in 1969. Prior to this change, interest payments on bonds and convertible debentures were deductible expenses for tax purposes, while dividend payments were not; thus many acquisitions were made

using convertible debentures, rather than common stock, of the acquiring company. The new law disallowed the deduction of interest in excess of \$5 million on convertible securities issued and employed for purposes of acquiring another corporation.

The final change that took place during this period saw the U.S. Justice Department launch a number of lawsuits in early 1969 which, for the first time, brought acquisitions of totally unrelated businesses (conglomerate acquisitions) under the scope of the anti-trust laws. Although most of these cases remained unresolved for many years, the launching of the lawsuits appears to have had an immediate effect on conglomerate stock prices, as the possibility of restraints on future acquisitions joined with other negative influences on the stock market to produce a severe price decline for most conglomerate stocks. As Chart 4 shows, this was a decline from which most conglomerate stocks never recovered.

At the same time as these changes were taking place in the regulatory environment, conditions in the U.S. economy and the stock market were beginning to deteriorate. The business recession and the declining market combined to place extraordinary pressure on the conglomerates. Their declining stock prices made acquisitions more difficult, while at the same time their profitability was reduced by the business recession. These factors combined to reveal what was rapidly becoming apparent: "that the process of putting conglomerates together tends to expand stock prices long before it expands the economic values on which stock prices ultimately depend."⁶ Many of the conglomerates were unable to report the earnings gains their shareholders had come to expect. The resulting decline in the price of conglomerate stocks as a group is clearly seen in Chart 4.

6. The Editors of Fortune, The Conglomerate Commotion, p. 95.

The combination of these changes in the regulatory and economic environment contributed to the decline in acquisition activity in the United States which continued from 1968 through 1973. In a similar fashion, the level of foreign acquisition activity in Canada declined steadily from 1969 through 1974, before rising in 1975.

As noted earlier, the surge in acquisition activity in the late 1960's and early 1970 was much stronger in the United States than in Canada, partly because the conglomerate corporation did not achieve the degree of prominence in Canada that it did in the United States.⁷ In addition, a study conducted in Canada in 1969⁷ found that only a small proportion of Canadian acquisitions were accounted for as "poolings" and that in general there were few instances of the accounting abuses often found in the United States.

The fewer excesses in Canada resulted in fewer changes in the regulatory environment than occurred in the United States. There were no changes in the application of combines law in Canada, and there were no changes in accounting standards until 1974.

But one important change was made in Canada with the coming into force of the revised Income Tax Act in January, 1972. The new Act allows a corporation to deduct interest on money borrowed for the purpose of acquiring shares in any other corporation, a change which might be assumed to have had, and to continue having, a positive influence on the level of acquisition activity in Canada. In any event, the post-1969 decline in acquisition activity was not as severe in Canada as in the United States.

7. Samuel A. Martin, Business Combinations in the '60s: A Canadian Profile.

Recently, stock prices in both Canada and the United States have recovered from 1974 lows in response to an anticipated and actual improvement in economic conditions. While it is beyond the scope of this paper to engage in detailed economic forecasts, a few comments on the outlook for acquisition activity may be in order. It seems reasonable to believe that acquisition activity in both countries has passed its low point and is in the process of starting upward again; and that, barring a major economic slowdown -- and market decline -- a more or less "normal" upswing in acquisition activity is apt to occur.

It is difficult to estimate when -- if ever -- another major boom in acquisition activity might occur. Based on previous experience, it would not be expected for another 20 to 30 years.

In other words, although a return to the level of acquisitions experienced in the boom of the late 1960's cannot be expected for the years immediately ahead, the probability appears to be that normal growth and cyclical trends are apt to be established.

6. Summary

This paper has examined recent trends in the level of foreign acquisition activity in Canada and has investigated some longer-term, as well as shorter-term, determinants of acquisition activity in the United States and Canada. The main conclusions are as follows:

1. The level of foreign acquisition activity in Canada is closely related to the level of acquisition activity in the United States.
2. Acquisition activity in the United States has displayed three distinct booms and numerous smaller cycles, most of which appear to have been reflected in Canada.

3. Of the indicators examined, stock prices appear to have the closest relationship with the cycles of acquisition activity. This is true for both Canada and the United States.
4. In each of the three major acquisition booms, there does not appear to have been an exceptional peak in production, commodity prices, or overall business activity.
5. Each of the three booms in acquisition activity occurred during a period in which there became apparent an exceptional economic justification for the consolidation of business organizations.
6. The recent several-year decline in acquisition activity in the United States was accompanied by a similar substantial decline in the number of foreign acquisitions in Canada.
7. Current evidence suggests that acquisition activity in both the United States and Canada has passed its low point and is in the process of moving upward again.
8. Although a return to the level of acquisition experienced in the late 1960's cannot be expected for the years immediately ahead, the probability appears to be that "normal" growth and cyclical patterns are apt to be established.

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